

The Honorable Marsha J. Pechman

UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF WASHINGTON
AT SEATTLE

IN RE WASHINGTON MUTUAL, INC.
SECURITIES, DERIVATIVE & ERISA
LITIGATION

No. 2:08-md-1919 MJP

FLAHERTY & CRUMLINE PREFERRED
INCOME FUND, INCORPORATED, et al.

No. C09-1756 MJP

-v.-

KERRY KILLINGER, et al.

**REPLY IN SUPPORT OF WAMU
OFFICERS' MOTION TO DISMISS
AMENDED COMPLAINT**

NOTE ON MOTION CALENDAR:
April 30, 2010

[OD-10]

ORAL ARGUMENT REQUESTED

TABLE OF CONTENTS

	Page
INTRODUCTION	1
ARGUMENT.....	3
A. The Court Should Dismiss Plaintiffs’ Fraud, Negligent Misrepresentation, and Section 10(b) Claims for Failure to Plead Reliance	3
1. Plaintiffs Fail to Allege Reliance on the Offering Circulars and Other Documents	3
2. Plaintiffs Do Not Claim to Have Heard or Relied Upon the WaMu Officers’ Alleged Oral Misrepresentations	5
B. The Court Should Dismiss the Claims under California Corporations Code Sections 25400 and 25500 Because Plaintiffs Do Not Allege That the WaMu Officers Sold or Offered to Sell the Preferred Trust Securities.....	5
C. Plaintiffs Have Failed to State a Claim Against the WaMu Officers Under California Corporations Code Section 25504.1	7
D. The One-Year Statute of Limitations Bars Plaintiffs’ Section 18 Claims	7
CONCLUSION.....	9

TABLE OF AUTHORITIES

Page(s)

CASES

<i>Binder v. Gillespie</i> , 184 F.3d 1059 (9th Cir. 1999)	4, 5
<i>Delta Savings Bank v. United States</i> , 265 F.3d 1017 (9th Cir. 2001)	4
<i>Freeman v. Laventhol & Horwath</i> , 915 F.2d 193 (6th Cir. 1990)	5
<i>Gawara v. United States Brass Corp.</i> , 63 Cal. App. 4th 1341 (4th Dist. 1998)	4
<i>In re 3Com Securities Litigation</i> , 761 F. Supp. 1411 (N.D. Cal. 1990)	5
<i>In re Alstom SA Securities Litigation</i> , 406 F. Supp. 2d 402 (S.D.N.Y. 2005)	8
<i>In re Enron Corp. Securities, Derivative & "ERISA" Litigation</i> , 465 F. Supp. 2d 687 (S.D. Tex. 2006)	8
<i>In re Federal National Mortgage Ass'n Securities, Derivative, and "ERISA" Litigation</i> , 503 F. Supp. 2d 25 (D.D.C. 2007)	8
<i>In re GlenFed, Inc. Securities Litigation</i> , 60 F.3d 591 (9th Cir. 1995)	5
<i>In re Hollinger International, Inc. Securities Litigation</i> , 2006 WL 1806382 (N.D. Ill. 2006)	8
<i>In re MDC Holdings Securities Litigation</i> , 754 F. Supp. 785 (S.D. Cal. 1990)	5
<i>In re Pfizer Inc. Securities Litigation</i> , 584 F. Supp. 2d 621 (S.D.N.Y. 2008)	8
<i>Kamen v. Lindly</i> , 94 Cal. App. 4th 197 (6th Dist. 2001)	6
<i>Kelley v. Rambus, Inc.</i> , 2008 WL 5170598 (N.D. Cal. 2008)	8
<i>McMahon v. Marsh & McLennan Cos.</i> , No. BC 339808 (Cal. Super. Ct. Los Angeles County 2009)	6

1	<i>Merck & Co. v. Reynolds,</i>	
2	2010 WL 1655827 (U.S. 2010).....	8
3	<i>Mirkin v. Wasserman,</i>	
4	5 Cal. 4th 1082 (1993).....	4, 5
5	<i>Reese v. Malone,</i>	
6	2009 WL 506820 (W.D. Wash. 2009)	7, 8
7	<i>South Oregon Barter Fair v. Jackson County,</i>	
8	372 F.3d 1128 (9th Cir. 2004)	4
9	<i>StorMedia Inc. v. Superior Court,</i>	
10	20 Cal. 4th 449 (1999).....	6
11	<i>Zucco Partners, LLC v. Digimarc Corp.,</i>	
12	552 F.3d 981 (9th Cir. 2009)	5

STATUTES

13	15 U.S.C. § 78r	7
14	28 U.S.C. § 1658.....	7
15	Cal. Corp. Code § 25400.....	6

Defendants Thomas W. Casey, Ronald J. Cathcart, Stephen J. Rotella, and David C. Schneider (collectively, the “WaMu Officers”) submit this reply in support of their motion to dismiss the Amended Complaint (the “Complaint”) [08-md-1919 Dkt. 433].¹ In addition, the WaMu Officers join and incorporate by reference the reply briefs filed by all other defendants, to the extent applicable.

INTRODUCTION

Plaintiffs’ response drops four claims against the WaMu Officers.² As to a fifth, Plaintiffs all but concede (except to preserve appeal rights) that this Court already ruled dispositively that a one-year statute of limitations governs § 18 claims. Plaintiffs have no answer to the arguments advanced by the WaMu Officers for dismissal of the remaining claims.

First, Plaintiffs concede—as they must—that they are obligated to plead *actual* reliance on the WaMu Officers’ alleged misrepresentations in order to state a claim for common law fraud, negligent misrepresentation, and violation of § 10(b) of the Exchange Act. In their bid to avoid dismissal of these three claims, Plaintiffs represent to the Court that a single paragraph out of their 324-paragraph Complaint included an allegation that Plaintiffs actually read and relied upon the Offering Circulars and other documents. *See* Opp’n at 23. But that representation is belied by the Complaint itself, which does *not* allege that Plaintiffs themselves read, heard, or actually relied upon the WaMu Officers’ purported misrepresentations, only that a *nonparty* did so. *See* ¶ 24. Even if paragraph 24 of the Complaint *did* allege that Plaintiffs read and relied upon the Offering Circulars—and it does not—its generic allegations of reliance do not meet the particularity requirements of Rule 9(b). *See In re Washington Mutual, Inc.*

¹ Unless otherwise indicated, citations to the Amended Complaint appear as “¶ __,” and all defined terms are those defined in the Amended Complaint.

² Therefore, the WaMu Officers do not further address these claims: constructive fraud (Cal. Civ. Code § 1573, Count Two), negligence (Count Three), violation of Cal. Corp. Code § 25504 (Count Six), and aiding and abetting (Count Seven).

1 *California Securities Litigation*, 2:08-md-1919 MJP, Dkt. No. 581; Lead Case No. C09-664
 2 MJP, Dkt. No. 63.

3 ***Second***, Plaintiffs blur the distinctions between this case and the securities
 4 putative class action in an effort to avoid dismissal by riding the coattails of the putative class
 5 action plaintiffs. Indeed, Plaintiffs invite the Court not to “revisit its prior rulings, including its
 6 decision to uphold the § 10(b) claims alleged in the class action.” Opp’n at 23 n.6. But the two
 7 cases involve different securities. And unlike the WaMu common stock at issue in the putative
 8 class action—which traded on the New York Stock Exchange—the Preferred Trust Securities at
 9 issue here were ***not*** traded on an open market. Accordingly, the *Flaherty* plaintiffs have not
 10 invoked—and cannot invoke—the fraud-on-the-market presumption, which is available only
 11 when the security at issue actively traded on an efficient market. Further, Plaintiffs’ claims for
 12 federal securities law violations amount to an afterthought: Plaintiffs added these claims only
 13 after this Court’s October 27, 2009 order in the putative class action, presumably in an attempt to
 14 leverage that ruling to avoid dismissal of their own deficiently-pleaded Complaint. The Court
 15 should not reward Plaintiffs for this transparent procedural gambit.

16 ***Finally***, Plaintiffs apparently concede that the WaMu Officers cannot be liable
 17 under California Corporations Code sections 25400 and 25500 unless they sold or otherwise
 18 engaged in market activity in the ***same*** security that Plaintiffs claim to have purchased. Plaintiffs
 19 attempt to confuse the issue in their opposition by submitting documents showing that the WaMu
 20 Officers sold WaMu common stock, a ***different*** security than the security at issue in this case.
 21 Because Plaintiffs cannot state a claim on these facts, the Court should dismiss the sections
 22 25400 and 25500 claims with prejudice. Plaintiffs’ remaining claims under the California
 23 Corporations Code fail for the reasons set out in the Initial Purchasers’ motion to dismiss and
 24 their reply brief in support thereof.

ARGUMENT

A. The Court Should Dismiss Plaintiffs’ Fraud, Negligent Misrepresentation, and Section 10(b) Claims for Failure to Plead Reliance

1. Plaintiffs Fail to Allege Reliance on the Offering Circulars and Other Documents

Plaintiffs admit that they must plead and prove actual reliance on the WaMu Officers’ allegedly false statements to state a claim for common law fraud, negligent misrepresentation, and violation of § 10(b) of the Exchange Act. Opp’n at 22–23, 36–37. In their opposition, Plaintiffs selectively quote from paragraph 24 of the Complaint to imply that Plaintiffs themselves read and relied on the applicable Offering Circulars, analyst reports, and the like. Opp’n at 23. In fact, the Complaint does *not* allege that *Plaintiffs* read and relied on these documents; instead, it alleges only that a nonparty investment advisor read certain categories of documents and relied on unspecified statements contained in those documents:

Non-party . . . Flaherty & Crumrine Incorporated [“FCI”], as the investment adviser/portfolio manager for [Plaintiffs], read and relied upon the Offering Circulars and the documents incorporated by reference, as well as analyst reports and credit rating agency reports concerning Washington Mutual that repeated and/or relied upon Defendants’ false and misleading statements.

¶ 24 (emphasis added).

As this Court recently held in the *California Securities Litigation*, “generic” allegations that a plaintiff read and relied upon documents, absent express allegations of “*which* documents they read, *when* the[y] read them or *how* they impacted their decision to purchase or retain WaMu debt securities,” do not pass muster under Rule 9(b). Order Granting Director Defs.’ & Deloitte’s Mot. to Dismiss at 11, *In re Washington Mutual, Inc. California Securities Litigation* [2:08-md-1919 MJP, Dkt. No. 581; Lead Case No. C09-664 MJP, Dkt. No. 63] (emphasis added). Further, even if non-party FCI was acting as Plaintiffs’ agent—and the Amended Complaint does not allege facts that would establish agency—Plaintiffs do *not* allege that FCI ever communicated the purported misrepresentations to Plaintiffs, or that, in turn,

1 Plaintiffs actually relied upon such information. *See, e.g., Mirkin v. Wasserman*, 5 Cal. 4th 1082,
 2 1095 (1993) (plaintiffs failed to establish indirect reliance where they did not “plead that the
 3 alleged misrepresentations ever came to their attention”); *Gawara v. U.S. Brass Corp.*, 63 Cal.
 4 App. 4th 1341, 1350–51 (4th Dist. 1998) (plaintiff claiming indirect reliance must plead reliance
 5 by agent or demonstrate that intermediary conveyed the misrepresentations to the plaintiff, who
 6 actually relied upon them).

7 Further, the Court’s earlier ruling on the WaMu Officers’ motion to dismiss the
 8 § 10(b) claims in the Securities class action does not establish the sufficiency of Plaintiffs’
 9 claims under the “law of the case” doctrine. Although the Securities class action and this
 10 litigation share certain questions of fact and law, they involve different *parties*, different
 11 *securities*, and different *allegations* of reliance. *See, e.g., Delta Savings Bank v. United States*,
 12 265 F.3d 1017, 1027 (9th Cir. 2001) (district court’s rulings in predecessor case involving some
 13 of the same parties and the same underlying transactions and occurrences does not constitute
 14 “law of the case” in subsequent action); *Southern Oregon Barter Fair v. Jackson County*, 372
 15 F.3d 1128, 1136 (9th Cir. 2004) (same) (cited by Plaintiffs).

16 Indeed, this motion raises arguments not previously addressed by this Court until
 17 this week’s ruling on the motions to dismiss *California Securities Litigation*. The motions to
 18 dismiss the Securities class action did not raise issues of reliance because the putative class
 19 action plaintiffs invoked the fraud-on-the-market doctrine, *see* Am. Consol. Compl. ¶ 639(a)–(i)
 20 [2:08-md-1919, Dkt. No. 293], which establishes a presumption of reliance in cases involving
 21 securities that trade in an efficient market. *Binder v. Gillespie*, 184 F.3d 1059, 1064 (9th Cir.
 22 1999). By contrast, the *Flaherty* Plaintiffs do not rely on the fraud-on-the-market theory to
 23 satisfy their burden of pleading actual reliance, as they have not alleged—and cannot allege—the
 24 existence of an efficient market for the Preferred Trust Securities at the time of the Offerings.³

25 ³ Plaintiffs claim to have purchased the Preferred Trust Securities—which were legally
 26 available only to qualified institutional buyers—in two private initial offerings. *See* ¶¶ 1–
 4; Levin Decl. (Dkt. No. 467), Exs. A & B. The Offering Circulars expressly warned that

1 *See id.* (presumption only available when plaintiff alleges the security at issue actively traded on
 2 an efficient market); *In re MDC Holdings Sec. Litig.*, 754 F. Supp. 785, 805 (S.D. Cal. 1990)
 3 (dismissing § 10(b) claim that attempted to invoke the fraud-on-the-market theory because
 4 plaintiffs had not sufficiently alleged existence of efficient market).⁴

5 **2. Plaintiffs Do Not Claim to Have Heard or Relied Upon the WaMu**
 6 **Officers' Alleged Oral Misrepresentations**

7 Even assuming that paragraph 24 sufficiently pleads Plaintiffs' reliance on the
 8 Offering Circulars and the documents incorporated by reference—and it does not—the
 9 Complaint contains no allegations that Plaintiffs heard or relied upon the WaMu Officers'
 10 purported *oral* misrepresentations. Plaintiffs do not argue otherwise. Thus, at a minimum, the
 11 fraud, negligent misrepresentation, and § 10(b) claims based on the alleged oral
 12 misrepresentations must be dismissed.

13 **B. The Court Should Dismiss the Claims under California Corporations Code**
 14 **Sections 25400 and 25500 Because Plaintiffs Do Not Allege That the WaMu**
 15 **Officers Sold or Offered to Sell the Preferred Trust Securities**

16 Plaintiffs tacitly concede their failure to allege that the WaMu Officers bought,
 17 sold, or offered to sell the same security that Plaintiffs claim to have purchased, as California

18 “[t]here has never been a market for the Trust Securities” and “[t]here can be no
 19 assurance that an active and liquid trading market for the Trust Securities will develop or
 20 be sustained.” Levin Decl., Ex. A at 20–21 and Ex. B at 24 (emphasis in original). Thus,
 21 because no efficient market existed when Plaintiffs allegedly purchased the Preferred
 22 Trust Securities, the “fraud on the market” presumption cannot apply. *See, e.g., Freeman*
v. Lavenhol & Horwath, 915 F.2d 193, 199 (6th Cir. 1990) (“fraud on the market”
 23 presumption of reliance not available as a matter of law to purchasers of newly issued
 24 bonds because the market for such securities “is not efficient or developed”).

25 Plaintiffs' failure to sufficiently plead a violation of § 10(b) dooms their § 20(a) claim.
 26 *Zucco Partners, LLC v. Digimarc Corp.*, 552 F.3d 981, 990 (9th Cir. 2009). Opening Br. at 5.

In addition, even where it otherwise applies, the fraud-on-the market theory cannot satisfy Plaintiffs' burden to plead actual reliance to state a claim for common law fraud and negligent misrepresentation under California law. *Mirkin*, 5 Cal. 4th at 1089; *In re GlenFed, Inc. Sec. Litig.*, 60 F.3d 591, 592 (9th Cir. 1995); *In re 3Com Sec. Litig.*, 761 F. Supp. 1411, 1419 (N.D. Cal. 1990). Opening Br. at 4.

1 Corporations Code sections 25400 and 25500 require. Instead, they respond to the WaMu
 2 Officers' motion to dismiss by seeking judicial notice of "the undisputed fact" that the WaMu
 3 Officers "sold Washington Mutual shares in 2006 and 2007." Opp'n at 36. But that "undisputed
 4 fact" has no bearing on these claims.

5 California Corporations Code section 25400(d) prohibits intentionally making
 6 false statements to inflate the price of a security, for the purpose of inducing others to buy the
 7 security at the artificially inflated price, while simultaneously "dumping" that same security.
 8 *See, e.g., McMahon v. Marsh & McLennan Cos.*, No. BC 339808 (Cal. Super. Ct. Los Angeles
 9 County Jan. 6, 2009) (tentative ruling; final judgment entered on March 3, 2009) (dismissing
 10 section 25400 and 25500 claims against defendants who admitted to selling securities but not the
 11 particular ones at issue; "the phrase 'such security' in Section 24500 points to the security in
 12 question, not all conceivable securities") [attached as Exhibit A to the Declaration of Steven P.
 13 Caplow; final judgment attached as Exhibit B to the Caplow Declaration]; *StorMedia Inc. v.*
 14 *Superior Court*, 20 Cal. 4th 449, 461 & n.13 (1999) ("The unlawful conduct is the making of
 15 false and misleading statements for the purpose of inducing the purchase or sale of a security
 16 **which the defendant is selling**, offering to sell, purchasing, or offering to purchase.") (emphasis
 17 added); *Kamen v. Lindly*, 94 Cal. App. 4th 197, 199, 206 (6th Dist. 2001) ("defendant must have
 18 engaged in both activities in order to be liable under section 25500"; finding that purchasers of
 19 S3 stock failed to state a claim against corporate officer who was not alleged to have "sold or
 20 offered to sell S3 stock"); Cal. Corp. Code § 25400(d) (prohibiting a buyer, seller, or offeror of
 21 securities from making false statements "for the purpose of inducing the purchase or sale of **such**
 22 security by others) (emphasis added).

23 Plaintiffs' claims revolve entirely around the Preferred Trust Securities, which
 24 they purchased. The Forms 4, however, which Plaintiffs submit as the subject of their request
 25 for judicial notice, do not show that the WaMu Officers ever sold or offered to sell the **Preferred**
 26 **Trust Securities**; instead, they show only that the WaMu officers sold WaMu **common stock**.

1 Because Plaintiffs have not alleged that the WaMu Officers bought, sold, or offered to sell the
 2 Preferred Trust Securities, Plaintiffs' fifth cause of action fails as a matter of law.

3 **C. Plaintiffs Have Failed to State a Claim Against the WaMu Officers Under**
 4 **California Corporations Code Section 25504.1**

5 Plaintiffs do not dispute that failure to adequately plead an underlying violation of
 6 California Corporations Code section 25401 means that they cannot state section 25504.1 claims
 7 against the WaMu Officers. The Court should dismiss Count Six for the reasons set forth in the
 8 Initial Purchasers' motion to dismiss, *see* Initial Purchasers' Opening Br. at 17–20 [2:08-md-
 9 1919, Dkt. No. 466], which the WaMu Officers joined, *see* WaMu Officers' Opening Br. at 8–9,
 10 and for the additional reasons set forth in the Initial Purchasers' Reply at 7–10, which the WaMu
 11 Officers also join.

12 **D. The One-Year Statute of Limitations Bars Plaintiffs' Section 18 Claims**

13 Plaintiffs do not dispute that they were on notice of their § 18 claims by late 2007.
 14 Nevertheless, they argue that they timely filed their § 18 claims because—according to
 15 Plaintiffs—the Sarbanes-Oxley Act (“Sarbanes-Oxley”), 28 U.S.C. § 1658(b), extended the
 16 statute of limitations to two years for § 18 claims. Plaintiffs' argument has no merit: Section 18
 17 remains governed by the one-year limitations period set forth in 15 U.S.C. § 78r(c), as this Court
 18 has already ruled. *See Reese v. Malone*, No. C08-1008MJP, 2009 WL 506820, at *9 (W.D.
 19 Wash. Feb. 27, 2009) (Pechman, J.) (Sarbanes-Oxley did not extend the one-year statute of
 20 limitations for § 18 claims).

21 Section 804 of Sarbanes-Oxley provides a two year statute of limitations for “a
 22 private right of action that involves a claim of fraud, deceit, manipulation, or contrivance in
 23 contravention of a regulatory requirement concerning the securities laws.” 28 U.S.C. § 1658(b).
 24 The majority of district courts—including this Court—that have addressed the issue have held
 25
 26

that section 804 does not apply to § 18 claims.⁵ *E.g.*, *Reese*, 2009 WL 506820, at *9; *Kelley v. Rambus, Inc.*, No. C 07-1238 JF (HRL), 2008 WL 5170598, at *9 (N.D. Cal. Dec. 9, 2008); *In re Pfizer Inc. Sec. Litig.*, 584 F. Supp. 2d 621, 642 (S.D.N.Y. 2008); *In re Fed. Nat'l Mortg. Ass'n Sec., Derivative & "ERISA" Litig.*, 503 F. Supp. 2d 25, 34–35 (D.D.C. 2007); *In re Enron Corp. Sec., Derivative & "ERISA" Litig.*, 465 F. Supp. 2d 687, 712–13 (S.D. Tex. 2006); *In re Hollinger Int'l, Inc. Sec. Litig.*, No. 04C 0834, 2006 WL 1806382, at *15 (N.D. Ill. June 28, 2006); *In re Alstom SA Sec. Litig.*, 406 F. Supp. 2d 402, 419–20 (S.D.N.Y. 2005). As this Court recognized in *Reese*, section 804, by its terms, “applies only to causes of action concerning fraud claims and therefore to claims which require the pleading of fraudulent intent or scienter.” 2009 WL 506820, at *9; *see also Pfizer*, 584 F. Supp. 2d at 642; *Alstom*, 406 F. Supp. 2d at 420–21; *Fed. Nat'l Mortg.*, 503 F. Supp. 2d at 35. Because fraudulent intent or scienter is not an element of a claim under § 18, section 804 does not control. *Reese*, 2009 WL 506820, at *9; *Pfizer*, 584 F. Supp. 2d at 642; *Enron*, 465 F. Supp. 2d at 712–13; *Alstom*, 406 F. Supp. 2d at 420; *Fed. Nat'l Mortg.*, 503 F. Supp. 2d at 35. Further, “nothing in the language or history of Sarbanes-Oxley indicates a clear intent to overrule” the express limitations period set forth in § 18. *Reese*, 2009 WL 506820, at *9; *see also Alstom*, 405 F. Supp. 2d at 420; *Hollinger*, 2006 WL 1806382, at *15. Plaintiffs cite only unpublished, out-of-district cases for the opposite conclusion and **concede** that this Court has already conclusively rejected their position. Indeed, they say only that they “assert[] the current argument to preserve [their] rights on appeal.” Opp’n at 26 n.10.

⁵ Neither the Supreme Court nor any Circuit Court has decided this issue. The Supreme Court’s recent decision in *Merck & Co. v. Reynolds*, No. 08-905, 2010 WL 1655827 (U.S. Apr. 27, 2010), does not bear on this issue, as that case construed section 804—not 15 U.S.C. § 78r, which governs § 18 claims. In *Merck*, the Supreme Court held that the statute of limitations on the plaintiffs’ § 10(b) claims did not begin to run until “a reasonably diligent plaintiff would have discovered ‘the facts constituting the violation,’” **including scienter**. *Id.* at *13–15. As this Court and others have recognized, § 18 claims “require[] only negligence, meaning that far less is required to alert a potential § 18 claimant of his claim.” *Kelley*, 2008 WL 5170598, at *9.

In sum, because Plaintiffs concede that they were on notice of their claims more than one year before they sued, the Court should dismiss the § 18 claims with prejudice.

CONCLUSION

For the foregoing reasons and the reasons set forth in their opening brief, the WaMu Officers respectfully request that the Court dismiss the Amended Complaint.

Dated this 30th day of April, 2010.

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CERTIFICATE OF SERVICE

I hereby certify that on April 30, 2010, the foregoing was electronically filed with the Clerk of the Court using the CM/ECF system which will send notification of such filing to all counsel of record who receive CM/ECF notification, and that the remaining parties shall be served in accordance with the Federal Rules of Civil Procedure.

DATED this 30th day of April, 2010.

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